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In the Supreme Court of the United States

OCTOBER TERM, 1940

No. 958

KETTLEMAN HILLS ROYALTY SYNDICATE NO. 1, A TRUST, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum opinion of the United States Board of Tax Appeals (R. 32–40) is not reported. The opinion of the Circuit Court of Appeals (R. 138–143) is reported in 116 F. (2d) 382.

JURISDICTION

The judgment of the Circuit Court of Appeals for the Ninth Circuit was entered December 19, 1940. (R. 143.) A petition for rehearing was filed January 17, 1941, and denied on January 21,

1941. (R. 144.) A petition for a writ of certiorari was filed April 17, 1941. The jurisdiction of this Court is invoked under Section 240 (a), Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the taxpayer trust is an association taxable as a corporation within the meaning of Sections 801 (a) (2) and 1001 (a) (2) of the Revenue Acts of 1934 and 1936, respectively.

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved are set forth in the Appendix, *infra,* pp. 12–16

STATEMENT

The facts as stipulated (R. 42–122), and found by the Board of Tax Appeals (R. 33–38), are as follows:

Robert Hayes Smith held a permit from the United States for prospecting for oil and gas on certain lands. By contract, on May 5, 1928, he authorized Associated Oil Company to attempt discovery of oil and gas, secure a Government lease, and operate the property, paying him a one-sixth royalty. This agreement was modified and supplemented on February 19, 1930. Likewise in 1928, Smith made a somewhat similar contract with Associated as to other lands respecting which he held a prospecting permit. (R. 33.)

On May 3, 1930, Smith assigned his interests in the contracts to one Jacoby, a duly licensed oil royalty broker, who acquired the contracts for the purpose of placing them in trust and receiving certificates of beneficial interest which he could sell to the public. On the same day taxpayer was organized, by execution of an agreement and declaration of trust on the part of Jacoby as "Subscriber" and three parties as "Trustees". Jacoby assigned his interests to the trustees as the entire corpus of the "trust" and received certificates representing 4,000 equal interests of the par value of $1,000 each, representing the entire beneficial interest. These were transferable by endorsement of the holders. They have since been acquired by various persons, the number ranging from 57 in 1931 to 628 in 1939. (R. 33–34.)

The "Agreement and Declaration of Trust" provided, *inter alia,* as follows (R. 34–36):

> That the trustees agree to hold in trust the property delivered to them, as well as all other property which they may acquire as such trustees and all moneys, properties and securities accruing therefrom that may be received by them, to handle, improve, manage and dispose of the same and to collect, receive and distribute the income and profits therefrom to the holders of certificates; that legal title, ownership and control of the estate is vested in the trustees; that the trustees shall conduct all business and execute all instruments under the name of Kettleman Hills Royalty Syndicate or other

name to be selected; that the trustees acknowledge receipt of the property which, with any other property which may be acquired by them for the purposes provided by the agreement, shall be received, held, owned, controlled, managed and applied to the uses mentioned in the instrument; that the trustees will carry out the obligations of Jacoby with Associated, including payment of taxes, execution of leases, drilling of any and all oil wells required or permitted, receiving, storing and selling oil, gas and gasoline, and will protect the interests under the agreement in any manner they may deem proper; that the trustees shall collect and receive the royalties and distribute the net income and profit therefrom to the holders of certificates; that they are authorized, in furtherance of the interests of the "trust estate" to develop and drill for oil and gas, to buy and sell oil, gas, gasoline or hydro-carbon substances, to enter into or acquire franchises, contracts or concessions in relation to the operation of the estate and to do all things necessary to the purposes of the organization * * *; that the trustees shall not be personally liable by virtue of any contract, but same shall fully bind the property of the trust estate; that all expenses, arising from contract or tort shall be paid out of the assets and properties of the trust estate; that the trustees shall bring any suits or actions necessary, and defend or compromise same, and pay judgments; that the trustees shall hold title to all property

and manage and control same and be free from control or management by certificate holders, who shall not have power to remove a trustee, except through the courts; that certificate holders shall not be liable for indebtedness or liability of the trust estate or its operation.

On April 27, 1931, the trustees, at the request of Associated, consented to an application by Smith as original permittee to the Secretary of the Interior for an extension of time for further exploration. They also entered into a contract as of June 15, 1931, after several months' negotiations with Smith, Associated, and representatives of the Department of the Interior, whereby Smith and Associated agreed to accept for the period up to April 1, 1931, a percentage of oil or gas under a unified cooperative development and conservation plan for the North Dome Kettleman Hills Oil Field in lieu of the royalty payment provided by the agreement of May 5, 1928. Associated agreed to pay Smith and taxpayer $5,000 and 7½ percent of amounts received by Associated under the plan of unified cooperative development as taxpayer's royalty on certain lands. Smith in turn authorized the payment of the moneys to taxpayer. A resolution by the trustees recited that this was to the best interests of the taxpayer. (R. 36.)

As to certain other lands, the trustees on September 20, 1933, with reference to a similar cooperative development plan, executed a "Lessors' and

Royalty Owners' Consent" that Smith and Associated might become members of Middle Dome Corporation, which should have the management of the cooperative development and conservation. The taxpayer thereby agreed to receive its pro rata part of the total production under the plan. The only income received by taxpayer has been under the contracts above described, which income, less expenses, has been distributed to the holders of beneficial certificates. (R. 37.) It is further stipulated concerning all the royalties received by the taxpayer in the tax years in question that they were received from the North Dome lands under agreement of May 5, 1928, providing that (R. 92):

> Second party [Associated] agrees to pay to first party [taxpayer] a royalty of 7½% of the value at the well of all oil and/or gas produced and sold by second party (except oil or gas used for production purposes or unavoidably lost) * * *, or, at first party's [taxpayer's] option, exercised not oftener than once in any one calendar year, upon sixty days' previous written notice, second party will deliver into first party's tanks on the said premises, or at the mouth of well to pipe line designated by first party, first party's 7½% of said oil.

and the later modifying agreements retaining this option provision. (R. 55–56, 119; see also R. 140.)

Taxpayer has no regular employees other than the trustees, two of whom act as counsel and bookkeeper, respectively. The trustees have also

transferred certificates of beneficial interest, made state and federal returns and reports, made an annual report to the certificate holders, corresponded with them with reference to income, corresponded with Associated, receiving monthly reports of production and discussing the selling price of oil and gas, and have had interviews with certificate holders and officials and employees of Associated. The trustees have kept a record of all meetings and resolutions. Moneys have been distributed to certificate holders four or five times a year, ranging from a total of approximately $6,000 in 1931 to a total of approximately $18,000 in 1938. (R. 37–38.)

Upon the basis of the foregoing facts, the Board held that the taxpayer was an association taxable as a corporation during the taxable years 1934, 1935, and 1936, and entered its decision affirming the Commissioner's determination. (R. 41.) From this decision the taxpayer petitioned for review to the Circuit Court of Appeals for the Ninth Circuit, which affirmed the judgment below.

ARGUMENT

The basic principles for ascertaining whether this trust is an association taxable as a corporation have already been outlined in four companion cases in this Court. *Morrissey* v. *Commissioner,* 296 U. S. 344; *Helvering* v. *Coleman-Gilbert,* 296 U. S. 369; *Swanson* v. *Commissioner,* 296 U. S. 362; *Helvering* v. *Combs,* 296 U. S. 365. Here the tax-

payer's request for certiorari is founded in substance upon the contention that the Circuit Court of Appeals for the Ninth Circuit has misapplied these principles to the particular facts. We submit that the decision of the Board of Tax Appeals, and of the Circuit Court of Appeals, is in accordance with the established law and that there is no conflict with the decisions of other circuits.

In the case at bar, taxpayer presents the question as exclusively whether it is "doing business," and relies upon certain cases involving the corporation tax law of 1909 (Act of August 5, 1909, c. 6, Sec. 38, 36 Stat. 11, 112–117), i. e., *Zonne* v. *Minneapolis Syndicate,* 220 U. S. 187, and *McCoach* v. *Minehill Railway Co.,* 228 U. S. 295. The problem is not whether a corporation should be taxed to the extent of its exercise of the privilege of doing business, but whether the taxpayer is more akin to a corporation than to the traditional type of trust. (See 296 U. S. 344, at 359.) In this connection taxpayer has admitted that its form and mode of procedure are quasi corporate in character. (R. 33.) Thus it has practically all the corporate characteristics considered by this Court in the *Morrissey* case, *supra,* including centralized management, with title vested in the trustees, continuity of interest through the issuance of transferable certificates, and limited liability. It is true that whether the trust has a business purpose, and whether its activities are calculated to advance that purpose, ~~and~~ are also relevant criteria in determin-

ing whether an association exists. But in this case more than mere trust powers were granted by the original agreement, for the trustees had the power to drill wells for oil and gas, to execute leases and agreements, to buy and sell oil, gas or gasoline, to execute negotiable paper, and to do anything otherwise necessary in their discretion. Moreover, the facts are that they did enter into contracts and joined in cooperative agreements for joint development of the land. They exercised business judgment in deciding under the option whether to receive payment in cash or in the form of oil. It is further obvious that the trust had a definite profit motive; and the Board of Tax Appeals has so concluded. (R. 38–39.) This Court denied certiorari on October 14, 1940, in *Lee H. Marshall Heirs* v. *Helvering,* No. 110, present Term, with respect to an organization which exercised no more of its powers. Moreover, it is established that in ascertaining the existence of an association, the main question is the scope of the powers conferred upon the trustees by the indenture, rather than the extent to which such powers were exercised. *Helvering* v. *Coleman-Gilbert,* 296 U. S. 369, 374. See *Wholesalers Adjustment Co.* v. *Commissioner,* 88 F. (2d) 156, 157 (C. C. A. 8th); *Sears* v. *Hassett,* 111 F. (2d) 961 (C. C. A. 1st); *Fidelity-Bankers Trust Co.* v. *Helvering,* 113 F. (2d) 14 (App. D. C.); *Commissioner* v. *Vandergrift R. & Inv. Co.,* 82 F. (2d) 387 (C. C. A. 9th). But cf. *Com-*

missioner v. *Gibbs-Preyer Trusts Nos. 1 and 2,* 117 F. (2d) 619 (C. C. A. 6th).

Taxpayer claims that the case at bar is in conflict with five decisions of Circuit Courts of Appeals. Two of these cases, *Gardiner* v. *United States,* 49 F. (2d) 992, and *Dunbar* v. *Commissioner,* 65 F. (2d) 447, were both decided by the Circuit Court of Appeals for the First Circuit some years before this Court laid down the basic principles during the October Term, 1935 (*Morrissey* v. *Commissioner* and companion cases). The general proposition for which the two cases stand, namely, that the "crucial test must be found in what the trustees actually do, not in the mere existence of long unused broad powers" (49 F. (2d) 992, at 996), has since been decided squarely to the contrary in that circuit. *Sears* v. *Hassett,* 111 F. (2d) 961, at 963. The rest of the cases on which taxpayer relies (*i. e., Cleveland Trust Co.* v. *Commissioner,* 115 F. (2d) 481 (C. C. A. 6th), No. 764, present Term, certiorari denied, March 17, 1941; *United States* v. *Davidson,* 115 F. (2d) 799 (C. C. A. 6th); and *Myers* v. *Commissioner,* 89 F. (2d) 86 (C. C. A. 7th)) represent a class of decisions which this Court has declined to review. (See Government's Petition for Certiorari in *Helvering* v. *Cleveland Trust Co., supra,* p. 14.)

CONCLUSION

The decision of the court below correctly applies the statute and the governing principles established by decisions of the court to the facts of this case.

There is no conflict of decisions, and the petition should therefore be denied.

Respectfully submitted.

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MAY, 1941.